

Chapter 9

Main Findings and Recommendations

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9.1 Main Findings

In this section we will summarise the findings presented in the previous chapters on the key causes of the shadow economy in Serbia and the mechanisms that contribute to its development. We will also present the results of an estimate of the extent of the shadow economy in relation to GDP, estimates of various forms of the shadow economy in the sectors of businesses and entrepreneurs and their characteristics, and an estimate of the effects that formalising the shadow economy can have on the government budget and economic growth. Finally, we will summarise findings that relate to the administrative and institutional capacity of government institutions tasked with overseeing the operation of business entities.

9.1.1 *Causes of the Shadow Economy*

Some of the fiscal causes of the shadow economy are the relatively high fiscal burden on labour, complex and expensive tax procedures, a complex and opaque tax system, the lack of organisation, training, and equipment at the Tax

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Administration, the low quality of public-sector services, and high tolerance of the shadow economy.

We have singled out the following features of the labour market that have a bearing on the growth of the shadow economy: taxation of labour; minimum wage; social benefits system; employment protection legislation; minimum wage regulation; unemployment benefits; and retirement rules. The most significant of these are the rules for taxing labour, primarily the high tax burden on lower-paid work caused by the low tax-exempt allowance, high contribution rates, and minimum contribution base. Since the natural zone for formalising the informal economy is around the amount of the minimum wage, a high burden on minimum wages implies high costs of formalisation, and thereby discourages it. This effect is compounded by the high minimum wage, which currently stands at around 50 % of the average wage, exceeding the recommended level by some 10 percentage points. The minimum contribution base makes part-time employment contracts unpopular, and also effectively prevents the introduction of special contractual arrangements at more favourable tax rates such as the 'mini jobs' and 'midi jobs' that have successfully contributed to the flexibility of the labour market in some European countries.

Apart from causes in the tax system and features of the labour market, other factors of particular importance in Serbia have to do with the unfavourable economic and regulatory environment. Of the economic conditions we can single out low productivity and widespread liquidity issues, especially pronounced in times of crisis. While low productivity forces business entities to shift at least part of their operations into the informal sector to be viable in the market, the lack of liquidity affects the taxpayer's decision to evade taxes and so preserve funds needed to pay suppliers. Regulatory constraints particularly include high administrative costs and legal insecurity. In addition there are many other factors that are the consequences of weak institutions and a chaotic system, such as issues with construction permits, inefficient market exit, and frequent abuses using 'phoenix companies'. The poor institutional framework is also reflected in a high degree of tolerance for the shadow economy on the part of the state and the high level of corruption. These two factors, coupled with the low quality of public services, further disincentivise taxpayers from paying their taxes.

Some of the major factors favourable to the shadow economy that are found in the financial sector are the major share of cash transactions in the total volume of payments, informal financing, and unregistered remittances sent by migrants residing abroad. Cash payments continue to account for a major portion of total payments in Serbia, although they have seen a downward trend of late. These circumstances have been further complicated by the fact that the high level of euroisation has stimulated moral hazard behaviour by transactors, while transactions have been made primarily in foreign currency and outside legal channels. Moreover, the volume of informal finance has grown with the shadow economy. The causes behind the use of informal sources of finance are poor local regulations and contract enforcement mechanisms, barriers to market entry, expensive formal finance, lack of financial products appropriate to consumer needs, inadequate tax regulations, and high tax burdens. Informal financing causes greater information

asymmetries between market participants, lack of tax revenues from these activities, and exclusion of formal financial intermediaries from the transfer of funds. This adversely impacts the development of the financial sector and the efficient allocation of finance. Finally, remittances from migrants abroad are a particularly significant source of foreign capital in Serbia, as their post-crisis amounts in absolute terms exceed all other categories of capital inflows from private and public sources. The vast majority of remittances enter the country through informal channels and are often not invested in productive activity; this has negative effects on economic growth and development.

9.1.2 Estimates of the Extent of the Shadow Economy and Tax Gap

The extent of the shadow economy in Serbia was estimated using three methods: MIMIC, Household Tax Compliance (HTC), and the Survey on Conditions for Doing Business in Serbia. The application of the MIMIC method found that across all sectors in Serbia the shadow economy stood at some 30 % of official GDP in 2010. Data for the same year resulted in an estimate of 23.6 % of GDP for the shadow economy, identified on the basis of household income and consumption (the HTC method). According to the Survey on Conditions for Doing Business in Serbia, the shadow economy in the business sector stood at some 21 % of GDP for the two major types of informal activity (illicit trade and undeclared work). Based on these results we can conclude that the total extent of the shadow economy in Serbia was 30 % of GDP, and that this was for the most part accounted for by trade in goods and undeclared work.

The study also estimated the tax gap in the collection of VAT, personal income tax, and social security contributions. The VAT gap was estimated at 2.5 % of GDP, while the gap in personal income tax and social security contributions was put at about 5 % of GDP. We believe that the estimates of tax gaps for the key forms of taxation are relatively reliable. By extrapolating these estimates we arrived at an approximate estimate of the total tax gap in Serbia, which we put at about 10 % of GDP. A similar figure was also obtained using the HTC method, which indirectly supports the above estimate.

9.1.3 The Shadow Economy in the Business and Entrepreneur Sector

We analysed the shadow economy in the business and entrepreneur sector by using data from the Survey on Conditions for Doing Business in Serbia based on three indicators. These were: (1) the share of business entities engaged in the shadow

economy in the total number of business entities; (2) the share of informal workers in the total number of workers, both overall and by type; and (3) the share of cash payments in the total volume of payments.

The Survey on Conditions for Doing Business in Serbia asked respondents whether their own business was engaged in the shadow economy, and found that 28 % of all business entities in Serbia did so. These businesses and entrepreneurs employed workers informally and/or made payments in cash even though they were VAT payers. The term ‘informal worker’ is used to describe workers employed without a contract, or those who do have contracts but only part of whose wage is officially declared, with the remainder paid in cash. The findings showed that there was a link between the shadow economy and the type and age of the business entity: entrepreneurs and new start-ups were more likely to engage in the shadow economy, while the common relationship between the shadow economy and the size of business entities, whereby smaller businesses are more likely to work in the shadow economy, could not be confirmed. Most business entities operating informally were in construction (42.9 %), as is also evidenced by most empirical research; this sector was followed by agriculture (33.8 %), catering (33.1 %) and transportation (32.7 %). According to region, business entities located in Central Serbia (excluding Belgrade) were the most prone to operate in the shadow economy, while those in Belgrade were least likely to do so (33 % versus 24.7 %).

A further two indicators of the shadow economy were based on respondents’ views on the participation of their own businesses compared to their opinions on how active other businesses from the same sector were. All types of shadow economy were represented to a much greater extent in ‘other’ businesses in the same sector than in the respondents’ own businesses. We therefore considered data obtained from owners/managers’ biased responses regarding their own business activity in the shadow economy as the lower limit of the shadow economy, while figures obtained on the basis of their subjective views on the participation of other businesses from the same sector were deemed to denote the upper limit. Hence, the share of employees working without formal contracts ranged from 1.9 % (lower limit) to 23.9 % (upper limit) of the total number of employees; the share of workers whose total wages were not declared varied between 3.8 and 24.7 %; while the share of turnover in cash ranged between 11.3 and 21.6 % of the total volume of turnover.

The results of econometric analysis based on the survey data show that several variables are statistically significant and represent important determinants for making decisions on whether or not to join the shadow economy. They confirm the findings of similar studies that entrepreneurs are more likely to operate informally. In addition, we found that size (as measured by the number of employees) and the VAT status of entity are significant. Doing business in particular sectors of economic activity, (construction) is statistically significant, while according to some specifications the transportation sector increases and the trade sector decreases the probability of participation in the shadow economy. Regional variables are not statistically significant. Finally, the business attitude towards justification of the shadow economy is also statistically significant, which leads to the

conclusion that measures aimed at changing opinions about the shadow economy should play a more pronounced role.

There is widespread competition from business entities operating in the informal sector. On average, entities claimed they lost nearly 28 % of their income from this competition, while almost 35 % stated that the shadow economy was a large or very large obstacle to doing business. This is particularly evident in the sectors of transportation and construction, where nearly all respondents said they were exposed to some type of competition from the shadow economy. Our analysis also found that competition from the informal sector was felt less by companies with foreign equity, as well as when informal activities are more likely to be detected. We found significant correlation between the various types of informal activity, so that making and receiving cash payments was often accompanied by employing undeclared workers and paying wages in cash.

9.1.4 Estimated Impact of Formalising the Shadow Economy

Based on our assessment of the tax gap, we estimate that a decrease in the extent of the shadow economy could, over a period of up to 3 years, result in additional revenues of between 0.8 and 1.1 % of GDP, while over a decade additional revenues of close to 2 % of GDP could be expected. When viewed in a broader fiscal context, additional revenues resulting from less informal activity will not make it possible to reduce tax rates, nor will they allow discretionary increases in public spending. The shadow economy must be addressed to compensate for the drop in revenues collected from consumption taxes that will occur due to the necessary reduction in the absorption gap. The current absorption gap, characterised by a balance of payments deficit of some 10 % of GDP, is unsustainable in the long run since it leads to continual growth of foreign debt and net foreign assets. A reduction of the absorption gap by some 5 percentage points of GDP is estimated to have an autonomous impact on the decline in VAT revenues of about 1 % of GDP. Moreover, autonomous growth of public expenditure can be expected in the long run as the population ages; it would thus be more favourable to ensure that additional expenditures can be met through better collection of existing taxes, rather than by increasing tax rates. If addressing the shadow economy generates additional revenue it should be used to reduce the fiscal deficit rather than to reduce tax rates or increase taxes in a discretionary manner.

Even though there has been a lot of empirical research on the effects of formalising the informal economy on economic growth, there are still no clear and unambiguous empirical or theoretical findings that indicate whether the shadow economy has a positive or a negative impact or what the direction of causality is (Schneider and Enste 2000). According to the findings of the survey carried out in Serbia and ten other Central and Eastern European countries for the period 2001–2010 using the MIMIC method, the effect of the shadow economy on official GDP is statistically highly significant and has the expected negative sign. The GDP per

capita coefficient indicates that if GDP per capita declines by 1 percentage point, the shadow economy will grow by between 0.6 and 0.7 percentage points, depending on the model used. In other words, if GDP declines in the future the shadow economy will increase as business entities seek to compensate for fewer opportunities in the formal sector. This result is evidence of the importance of maintaining macroeconomic stability and creating conditions for future economic growth, as these are major components of successful strategies designed to formalise the informal economy.

9.1.5 The Administrative Capacity of Institutions Tasked with Overseeing Business: Labour Inspectorate, Market Inspectorate, and Tax Administration

The Labour Inspectorate is charged with tackling informal employment, or ‘working in the shadow’. When workers without employment contracts are discovered at a business the employer is given a deadline for either signing contracts with those employees or letting them go. The employer has a brief window to notify the Inspectorate of the steps taken. Although this procedure is clearly aimed at protecting workers without contracts, its preventive role can be disputed since there is no credible threat of sanctions to prevent future non-compliance. Even though the law provides for substantial fines for these offences they can only be handed down by the courts, and the procedure for proving breaches of the law is very demanding. The Inspectorate is even more constrained in its oversight of completely unregistered businesses or ‘phantom firms’, since access to their premises needs police assistance. Respondents’ estimates of the extent of informal employment made in the Survey on Conditions for Doing Business in Serbia are relatively high, especially in the sectors of construction, catering, trade, and industry. Similarly, estimates of the extent of the practice of paying a portion of wages while evading taxes and contributions for formally declared workers were also high. It comes as no surprise, therefore, that respondents had mixed views regarding the efficiency of the Labour Inspectorate. Nonetheless, this service was ranked slightly higher than both the Tax Administration and the Market Inspectorate, which corresponds to the finding that the principal issue does not lie with the capacities of the staff and the organisation of the Labour Inspectorate: rather it is prevented from being more effective in tackling informal employment and undeclared earnings by lack of resources and an inadequate statutory framework.

The primary task of the Market Inspectorate is to ensure the implementation of the Law on Trade and, in doing so, prevent various forms of illicit trade. Goods are most often sold in the informal sector through personal advertisements, in markets, in undeclared stores or self-employed craftsmen’s shops, from improvised roadside stalls, and at illegal distribution centres. When the Market Inspectorate establishes that an infringement has taken place it cannot impose a fine but must bring

proceedings in court. Market inspectors may issue rulings that require the infringement to be remedied, temporarily ban trading in particular goods or provision of particular services and temporarily close down a retail or wholesale outlet, or call for goods to be confiscated. The Market Inspectorate's remit is very broad and is governed by myriad laws and bylaws, which clearly impedes its efficiency and often leads to overlapping with other sectoral inspection services, including the Municipal Inspectorate. As regards its organisation, the Inspectorate is very fragmented, both horizontally and vertically, which hinders its effectiveness. Even though respondents in the Survey on Conditions for Doing Business in Serbia generally viewed it in a positive light, the Market Inspectorate scored slightly lower than both the Labour Inspectorate and the Tax Administration.

The Tax Administration was also less than efficient when uncovering tax evasion, which is the consequence of its lack of human and financial resources, inadequate staff structure, and systemic exchange of data with other government bodies aimed at discovering tax evasion. According to 2011 data the Republic of Serbia Tax Administration employed 6,165 staff, which is less than optimal given the number of taxpayers and international standards. Of the total number only 55 % have university degrees and the average age of employees is 49. In addition, many staff are tasked with receiving and technically processing tax filings, while the number of people carrying out tax audits is inadequate. The total budget of the Tax Administration is lower than necessary, and as a result salaries are low, which incentivises younger staff to leave after gaining experience in tax audit, which in turn has an adverse impact on audit quality and overall Tax Administration efficiency. The fact that business processes are not automated, that there is no cross-checking system to access and compare data from other government bodies (e.g., Real Estate Cadastre, Pension and Disability Insurance Fund, local Public Revenue Administrations, the police, etc.), that the mechanisms used to select taxpayers for audit are sub-optimal, and that the staff structure is inadequate, all result in a low likelihood of uncovering tax evasion, which serves as an incentive to operate in the informal sector.

9.2 Recommendations for Formalising the Shadow Economy

9.2.1 Strategy for Formalising the Shadow Economy

A successful policy to formalise the shadow economy must reduce the entry of new participants and foster the formalisation of existing participants by moving their activities from the shadow to the formal economy. This requires a strategy that addresses the root causes and mechanisms that contribute to its development: excessive tax burden, over-regulation of economic activity, and weak and ineffective government bodies. The causes of the shadow economy are many and varied

and multiple methods are needed to reintegrate it with formal channels. Policies designed to reduce the shadow economy can be divided into general reforms that address the shadow economy by building a favourable environment for doing business in the formal sector, incentives directly aimed at the shadow economy, and building the administrative capacity of the state.

Business entities decide how to operate on the basis of their assessment of the costs and benefits associated with doing business in either the formal or the shadow economy. Therefore any policy aimed at formalising the shadow economy should change the cost-benefit ratio for both the shadow and the formal economies.

There have been frequent attempts to change this cost-benefit ratio in the shadow economy by increasing administrative repression (i.e., through better detection and greater penalties). The policy for reducing the extent of the shadow economy pursued by most European countries up until 2000 was founded on exactly these repressive measures (Williams et al. 2008). However, the experiences of these countries, as well as of Serbia and Yugoslavia since the 1990s, show that this is neither the only nor the best avenue of approach, since relying solely on repressive methods without tackling the underlying causes of the shadow economy decreases economic activity by reducing the shadow economy without a corresponding increase in the formal economy (Krstić et al. 1998; Williams 2005). The use of repressive measures does, however, yield good results when the aim is to prevent entities joining the informal economy or to close down businesses already operating in the shadow economy, rather than to move business entities from the shadow to the formal economy.

Another means of changing the cost-benefit ratio in the shadow economy is to use various measures to reduce the benefits enjoyed by entities operating in it. This can be accomplished primarily by cutting costs (reducing the burden of taxes and business regulations) and increasing the benefits in the formal economy (e.g. by providing access to incentives and loans) in order to make operating in this sector more attractive. This can be achieved through preventive measures and incentives. Preventive measures can prevent the emergence of the shadow economy by reducing the tax burden and allowing new types of formal work. Preventive measures are directly aimed at participants in the shadow economy and are intended to induce them to formalise their operation. They include amnesties at the individual or general level for those wishing to join the formal sector, business advisory and support services, and targeted direct and indirect tax breaks for employing declared workers.

The practical task and key challenge for economic policy in Serbia is to develop a well-balanced combination of incentives and sanctions that will maximise the formalisation of participants in the shadow economy—businesses, entrepreneurs, and workers—and result in the loss of as little GDP or overall employment as possible. Ideally, the admixture of these incentives and penalties should comprise incentives aimed at incorporating those population groups that are excluded from the formal economy and re-integrating businesses and entrepreneurs that have left the formal economy due to high taxes, rigid regulations, or the economic crisis; and

sanctions designed to discourage voluntary, opportunistic use of the shadow economy to generate excessive profits through illegal cost-cutting.

The key prerequisite for a successful strategy to formalise the shadow economy is to complete transition and stabilise the legal and institutional structures of society, and then achieve and maintain macroeconomic stability and create pre-conditions for economic growth. The impact of these factors on the shadow economy is just one of their many desirable effects. The econometric findings presented in Chap. 6 indicate that an increase in registered GDP leads to a drop in the extent of the shadow economy. In other words, if GDP were to decline in the future the shadow economy would increase, since business entities would endeavour to compensate for fewer business opportunities in the formal sector by working in the shadow economy. In these circumstances the measures proposed will not be fully effective.

The econometric analysis shows that there are no statistically significant differences in the involvement of individual sectors in the shadow economy, except for in construction and trade. Thus the proposed measures for formalising the shadow economy are mainly sector-neutral; i.e., address all sectors equally. An exception to this is measures aimed at the construction sector and some services.

We propose a set of preventive measures and incentives aimed at formalising the shadow economy that cover tax policy and regulation, labour market institutions, and the financial sector. The recommendations that entail building the administrative capacity of government bodies relate primarily to the institutions that oversee businesses with informal employees and/or that make and receive cash payments: the Tax Authority, the Labour Inspectorate, and the Market Inspectorate. These recommendations are based on the analysis of the operation of these institutions presented in the preceding chapter. Table 9.1 at the end of this chapter shows the key recommendations for formalising the shadow economy for each of these areas, their sectoral coverage, the institutions responsible for conducting such measures, and the expected outcomes of their implementation.

9.2.2 Fiscal Policy Measures

Fiscal policy includes tax policy, public expenditures policy, and public debt management. The main factors affecting the formalization of the shadow economy are the characteristics of the tax and public expenditures system, while public debt policy does not have a substantial bearing on the informal sector.

The key measures that can be applied to combat the shadow economy within the framework of tax policy are:

- Reducing distortions introduced by taxes;
- Reducing tax compliance costs;
- Reducing the return to tax evasion, and
- Reducing tolerance of the shadow economy.

Table 9.1 Recommendations for formalising the shadow economy

Fiscal policy			
Measure	Sectoral coverage	Institutions	Expected outcome
Reduce fiscal burden on labour (see section on features of the labour market)	All sectors	Ministry of Finance and Economy	Lower extent of shadow economy in employment and medium-term increase in rate of registered employment
Remove tax breaks for corporate income tax and harmonise taxation of property of both individuals and legal entities	All sectors	Ministry of Finance and Economy	Less distortion generated by tax system and legal tax avoidance. Slight increase in public revenue
Reduce and simplify tax procedures	All sectors	Ministry of Finance and Economy/Tax Administration	Lower cost of administering taxes and greater readiness of taxpayers to pay taxes
Increase number of Tax Administration staff engaged in audits, improve their qualifications, and improve methodology used in selecting entities to be audited	All sectors	Ministry of Finance and Economy/Tax Administration	Greater cost of tax evasion and, consequently, less evasion
Improve consistency of implementation of statutory penalties for tax evasion	All sectors	Ministry of Finance and Economy/Tax Administration/courts	Greater cost of tax evasion and, consequently, less evasion
Ban sale of new industrial products in flea markets, farmers' markets, and roadside stalls	All sectors	Municipal Police	Reduction in volume of shadow economy in trade in goods
Register unregistered buildings for tax purposes	All sectors	Ministry of Finance and Economy/Local Tax Authorities/Cadastral	Fewer untaxed buildings
Reassign Tax Administration staff from administrative tasks to uncovering visible tax evasion (online, at catering establishments, etc.)	All sectors	Ministry of Finance and Economy/Tax Administration	Reduction in volume of shadow economy in trade in goods/services
Broaden application of statutory provisions for cross-checking property and income	All sectors	Ministry of Finance and Economy/Tax Administration	Less evasion of income tax

(continued)

Table 9.1 (continued)

Fiscal policy			
Measure	Sectoral coverage	Institutions	Expected outcome
Improve co-ordination between Tax Administration and other government bodies (police, social security funds, cadastre, local tax authorities, Business Registries Agency, Central Securities Depository, etc.), particularly in exchange of information	All sectors	Ministry of Finance and Economy/Tax Administration/Police/Cadastre/Central Securities Depository/Business Registries Agency	Greater probability of detecting unreported income and property
Improve activity by government in collecting taxes on reported income	All sectors	Ministry of Finance and Economy	Less reported and uncollected taxes
Credible commitment by state to abandoning practice of writing off interest on back taxes	All sectors	Ministry of Finance and Economy	Greater readiness of taxpayers to settle tax liabilities on time
Educate the public about the importance and value of services provided by the government and the drawbacks of the shadow economy through the public education system and the media	All sectors	Government of Serbia/Ministry of Education and Science/Ministry of Culture and Information	Greater tax morality
Invest effort in systematically improving the quality of public services (education, healthcare, administrative procedures, etc.)	Public services	Government of Serbia/all Ministries	Greater readiness of taxpayers to pay taxes
<i>Features of the labour market</i>			
Measure	Sectoral coverage	Institutions	Expected outcome
Lower fiscal burden on lower-paid work by increasing of tax-exempt allowance to level of minimum wage	All sectors	Ministry of Finance and Economy	Greater formal employment of lower-qualified workers, particularly in labour-intensive sectors
Remove minimum base for social insurance contributions	All sectors	Ministry of Finance and Economy	Greater formal employment of part-time workers, particularly those earning less

(continued)

Table 9.1 (continued)

Fiscal policy			
Measure	Sectoral coverage	Institutions	Expected outcome
Introduce more favourable tax treatment for 'mini' and 'midi' jobs	All sectors	Ministry of Finance and Economy	Greater formal employment of part-time workers, particularly those earning less
Introduce more favourable tax treatment for seasonal workers in agriculture, catering, tourism and construction	Agriculture, catering, tourism, construction	Ministry of Finance and Economy	Greater registered employment in seasonal jobs
Consider introduction of different contribution rates by sector or progressive social security contributions	Not defined	Research institutions	Based on findings of study
Reduce minimum wage from current level of 50 % of average wage to around or under 40 %	All sectors	Social and Economic Council	Increase in formal employment of minimum-wage earners
Reduce increased hourly rates for overtime work	All sectors	Ministry of Labour, Employment and Social Policy	Increase in formal hours worked by employees
Link severance payments to years of service with last employer rather than total years of service	All sectors	Ministry of Labour, Employment and Social Policy	Increase in formal employment of older workforce
Extend maximum duration of fixed-term contracts to 3 years	All sectors	Ministry of Labour, Employment and Social Policy	Increase in formal employment of younger workforce
Increase retirement age threshold, introduce actuarial adjustment of pensions to reflect expected use of retirement payments	All sectors	Ministry of Labour, Employment and Social Policy	Increase in formal employment of older workforce
Introduce in-work benefits	All sectors	Ministry of Labour, Employment and Social Policy	Greater activity and formal employment of beneficiaries of social welfare payments and other transfers
Support formal self-employment through grants and start-up loans	All sectors	Ministry of Labour, Employment and Social Policy and National Employment Service	Shift from informal employment into formal self-employment

(continued)

Table 9.1 (continued)

<i>Fiscal policy</i>			
Measure	Sectoral coverage	Institutions	Expected outcome
Introduce micro-lending facilities	All sectors	Ministry of Finance and Economy and National Bank of Serbia	Shift from informal employment into formal self-employment; increase in self-employment
Increase powers of Labour and Market Inspectorates, including entitling inspectors to audit unregistered businesses and impose penalties	All sectors, particularly those with major presence of informal activities	Ministry of Labour, Employment and Social Policy, Ministry of Trade and Telecommunications, and Ministry of Justice	Less informal employment in both formal and informal businesses
Introduce risk assessment and risk management system in inspection oversight	All sectors, particularly those with major presence of informal activity	Ministry of Labour, Employment and Social Policy, Ministry of Trade and Telecommunications	Less informal employment in both formal and informal businesses
<i>Financial sector</i>			
Measure	Sectoral coverage	Institutions	Expected outcome
Curb transactions in cash and incentivise cashless payments (incentives vs. repressive measures)	Services, hospitality, construction, transportation, trade	Ministry of Finance and Economy, NBS, commercial banks	Less concealment of portions of income generated in cash; substantial decrease in informal cash payments
Reduce extent of informal finance	All sectors	Ministry of Finance and Economy, NBS, commercial banks and other financial intermediaries	Less uncertainty, efficient allocation of funds, greater employment and more fiscal revenue from formal activity. Greater supply of finance would affect its cost and availability
Formalise remittances from abroad transferred through informal channels	Trade, other services, hospitality, construction, and potentially other sectors	NBS, Ministry of Finance and Economy, commercial banks and other financial intermediaries	Greater competition and lower costs of formal money transfers would stimulate migrant interest in transferring remittances through formal channels. This should foster domestic saving and new investment

(continued)

Table 9.1 (continued)

Fiscal policy			
Measure	Sectoral coverage	Institutions	Expected outcome
<i>Business environment</i>			
Measure	Sectoral coverage	Institutions	Expected outcome
Resolve issue of 'phoenix companies' (and consider establishing registry of bans imposed on business owners and managers in criminal or other proceedings)	All sectors	Ministry of Finance and Economy/Business Registries Agency/Courts	Tax evasion and non-payment of commercial liabilities prevented
Introduce SME Test and Standard Cost Model	All sectors	Government of Serbia/Regulatory Reform Office	Undue increases of administrative costs and obstacles to doing business in formal sector prevented
Simplify regulatory (administrative) requirements	All sectors	Government of Serbia/Regulatory Reform Office	Lower administrative burden; constraints to business operations removed
Improve regulatory framework to enable relevant stakeholders to take part in the consultation process	All sectors	Government of Serbia	Private sector participates in consultation and law drafting process; constraints to doing business and incentives for shadow economy reduced
Adopt bylaws in a timely fashion	All sectors	Government of Serbia	Legal insecurity removed
Reduce unfair competition	All sectors	Ministry of Foreign and Internal Trade and Telecommunications	Lower share of shadow economy in trade in goods
Establish an e-portal for licences, permits, approvals, and consents	All sectors	Government of Serbia	Lower start-up costs
Remove barriers to entry to particular sectors	Multiple sectors	Multiple regulatory bodies	Lower start-up costs and fewer barriers to entry
Establish a publicly accessible electronic legislation registry	All sectors	Government of Serbia	Lower cost of doing business
Improve construction permitting process	Construction	Ministry of Construction and Urban Planning/local authorities	Easier start-ups; less employment of workers and businesses from informal sector

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Table 9.1 (continued)

Fiscal policy			
Measure	Sectoral coverage	Institutions	Expected outcome
'Legalise' buildings without permits	All sectors	Ministry of Construction and Urban Planning	Making assets tradable, fungible and wholly available for legal transactions
<i>Outreach</i>	All sectors	Government of Serbia	Less tax evasion; or more incentive to shift from shadow to formal economy

Reducing Distortions Introduced by Taxes

The extent of distortions introduced by taxes stands in proportion to the square of the tax rate, meaning that higher tax rates also introduce higher distortions. Tax rates in Serbia are generally relatively low, and so the distortions are not substantial. An exception to this rule is the total fiscal burden on labour, which stands at some 39 % in Serbia, slightly lower than in developed EU member states but greater than in countries at similar levels of development (Arsić et al. 2010). Therefore total taxes on labour in Serbia are high and create incentives for tax evasion. The high tax burden is a particular constraint on labour-intensive sectors of activity such as the textile industry and services. A major reduction in the fiscal burden on labour would have a positive impact on the readiness of taxpayers to actually pay their taxes. Detailed recommendations on the taxation of labour are presented in the following section, which deals with measures aimed at the labour market.

In addition to the high fiscal burden on labour, the highest marginal rate¹ of the regular annual property tax, standing at 2 %, is considered to be relatively high and serves to foster various forms of tax evasion. Any reform of property tax, assuming this type of taxation remains progressive, should therefore limit the top marginal tax rate to 1 %. This change would not have much significance for the budget, but would be justified from the point of view of both reducing the shadow economy and enhancing efficiency and equity.

Distortions introduced by taxes also depend on the number of tax rates, breaks, and exemptions for each type of tax, special tax regimes, etc. The more rates there are for each personal income tax, the greater the opportunities for tax evasion. In general, the Serbian tax system is well designed in this respect and does not offer much incentive for tax evasion. It would, however, be desirable for future reforms of the VAT framework to gradually introduce a single tax rate, as this would reduce the scope for tax evasion. The most tax breaks and exemptions apply to corporate

¹ The marginal tax rate is calculated by dividing the increase in tax by the increase in the tax base.

income tax. Although these breaks for the most part do not contribute to the shadow economy, they nonetheless facilitate tax avoidance and tax fraud, and as such should be gradually abolished.

Reduce Tax Compliance Costs

Greater costs associated with administering taxes encourage taxpayers to evade them. The tax compliance costs grow larger as the number of taxes in the system increase, become more complicated, as the number of payments per year increases, and as e-filing opportunities become more limited. The tax compliance costs are particularly relevant for small taxpayers (e.g., small and micro-businesses, entrepreneurs) whose incomes are low. One of the main measures to reduce tax compliance costs is continual re-examination of the justification for numerous fiscal and quasi-fiscal charges. Complicated and unclear tax regulations increase tax compliance costs and facilitate accidental or deliberate tax evasion. However, the assessment of some taxes—such as the corporate income tax—is not aligned with international accounting standards, which increases compliance costs, particularly for foreign companies doing business in Serbia. Although the divergence of accounting standards from international practice is probably not a major cause of the shadow economy, bringing them into line with global standards is important in improving general conditions for doing business in Serbia.

Simplifying tax procedures to cut the number of tax payments each year would increase e-payment options, reduce tax compliance costs, and increase the readiness of taxpayers to pay their taxes voluntarily.

Reforming the system of quasi-fiscal charges is an important precondition for improving the business environment and reducing the costs of doing business. The reform process begun in 2012 with the removal of 138 individual dues is an important step towards improving the business environment; it has resulted in the abolishment of many unjustified charges and the definition of statutory procedures for the introduction of new dues; moreover, all charges are now paid into the national budget. Besides removing the remaining unjustified charges, future efforts should focus on combining similar fees and appropriately naming and categorising them. It is particularly important to improve the parameters used in defining the charges that are justified: these include adjusting the tax burden to the financial strength of each taxpayer, aligning fees with the expenses associated with the provision of a service by the government, and bringing the amounts of charges into line with the benefits enjoyed or damage caused by the payer. Systemic limitations need to be introduced to avoid a return to an economically distorting and unfair system of quasi-fiscal charges. With this in mind, it is important to again apply the gross budget principle consistently, as well as to introduce any fiscal and quasi-fiscal dues exclusively by law.

Reduce the Return to Tax Evasion

Tax evasion can be viewed as a rational choice on the part of taxpayers that depends on the cost-benefit ratio of evading taxes. Hence, to reduce tax evasion its benefits must be reduced and its costs increased. An increase in the costs of tax evasion can be brought about by increasing the probability of detection, as well as by increasing penalties in the case of evasion. Empirical research shows that increasing the probability of detection is a greater deterrent to evasion than imposing harsher penalties. Reforming the Tax Administration is the one decisive precondition for increasing the probability of detecting tax evasion: this means carrying out more frequent audits, while the probability of a taxpayer being audited should be based on the risk of that taxpayer actually committing tax evasion.

In addition, the probability of prosecuting tax evasion needs to be increased. For this to happen, systematic measures must be taken to tackle corruption at the Tax Administration, as well as to improve co-operation between the Tax Administration and other government bodies. Efficient prosecution of tax evasion cases also depends on changes to criminal legislation, training of judiciary bodies, and combating corruption within the judiciary.

Increase Tax Morals

The readiness of taxpayers to engage in evasion does not depend only on the cost-benefit ration, but also on their moral views of tax evasion. Moral views of how justified tax evasion is depend on numerous factors, such as tradition, how other taxpayers behave, the existence of privileged taxpayers, government tolerance of tax evasion, the quality of public services, etc. There are many ways in which governments can encourage taxpayers to regard evasion as immoral, such as incorporating anti-evasion messages into the education system and media campaigns. The readiness of individuals to pay taxes depends on the behaviour of other individuals and their estimated readiness to pay their taxes. If the government is consistent and unselective in tackling tax evasion, taxpayers will be more certain that others will pay and will be more willing to pay themselves.

Reduce Tolerance for the Shadow Economy

Tax evasion is more or less tolerated in most democratic societies, and the shadow economy is often treated as an activity that contributes to the social security of the less well-off. However, the high tolerance of the shadow economy in Serbia does not extend only to vulnerable groups. Reducing tolerance for the shadow economy in Serbia is necessary to reduce the extent of informal operations. This primarily entails consistently and unselectively banning activities that result in visible and noticeable tax evasion. Specifically, in the case of Serbia, this would entail:

- Introducing a ban on the sale of new industrial products in flea markets, farmers' markets, and roadside stalls.
- The fact that there are many untaxed buildings sends a clear message that the government tolerates the shadow economy.² A major increase in the reach of taxation of real property would clearly indicate that the government is becoming less tolerant of the shadow economy. To this end, national authorities could provide technical support to local bodies and introduce a system of incentives and penalties for local authorities dependant on their degree of success in increasing the reach of taxation and property tax collection.
- Many forms of shadow activity are openly engaged in via the Internet, classified ads in newspapers, etc. These could be prevented relatively easily, but this is not done due to the passive stance of the Tax Administration, which does not monitor new channels of tax evasion. Particularly significant in this respect is the widespread practice of catering establishments (restaurants, coffee bars, etc.) not issuing fiscal receipts or not assessing and paying VAT, although added value is high in this sector. This type of tax evasion can be uncovered without a great deal of additional training for tax inspectors, since evasion is obvious and easy to discover. Therefore, since the introduction of e-filing will release many Tax Administration staff from their current technical and administrative duties (receiving and certifying tax filings, entering data into the database, etc.), it is recommended that they be reassigned to audits of sectors where tax evasion is obviously taking place.
- Over the past several decades there have been clear discrepancies between the amount of property owned by many Serbian nationals and income reported to the Tax Administration. The absence of any reaction from the Tax Administration is a form of tolerance for tax evasion—and for tax evasion that has nothing to do with social security. Regulations on cross-checking property and income must be implemented without delay, and those individuals whose assets far exceed their declared income must be subject to ex-post income tax. The government's decision to finally implement statutory provisions allowing the cross-checking of property and reported income is a major step forward in tackling the shadow economy. That said, it is crucial to ensure that the Tax Administration continues to cross-check property and income rather than for this effort to be a one-off exercise. For these measures to succeed fully, the Tax Administration needs to co-operate with other government bodies in order to increase its capacity for uncovering the real owners of property in Serbia. Establishing sound co-operation with foreign tax authorities is also necessary to identify and appraise the assets that Serbian nationals hold abroad.

² According to Tax Administration estimates, some 15 % of flats in residential buildings, as well as office buildings, are untaxed; for individual houses, the figure stands at over 20 % (Arsić and Randelović 2012).

Encourage Taxpayers to Settle Reported Tax Liabilities Fully and on Time

The practice of companies making tax filings and then failing to pay is widespread in Serbia. The reason for this is in the poor liquidity of companies, which is often actually insolvency in disguise. The Tax Administration often tolerates this behaviour to avoid forcing taxpayers into formal insolvency, which generally ends in many workers losing their jobs. This indicates that non-payment of taxes in Serbia, even when not formally the result of the shadow economy, is a significant type of financial indiscipline that results in both lower fiscal revenues and less equality for business entities. Statutory limitations on payment deadlines in commercial transactions are a major step forward in establishing financial discipline. An advantage of the proposed measure is that the deadlines are the shortest in cases where the government owes money. Yet the reach of this measure is relatively constrained by the fact that financial indiscipline is primarily caused by the presence of insolvent businesses in the market. The decisive factor in establishing financial discipline, therefore, would be the efficient and non-selective implementation of bankruptcy procedures, which would remove insolvent entities from the market. In that context, the suspension of automatic insolvency by the Constitutional Court is a step backward. To establish financial discipline it is also important to raise prices charged by infrastructure operators so that they cover costs.

Abandon the Practice of Writing off Interest for Late Payment of Taxes

In addition to being the consequence of tolerating a large number of insolvent companies active in the market, fiscal indiscipline is also partly caused by the periodical reductions in and write-offs of back taxes. Over the past two decades Serbia has, from time to time (generally just before or after a general elections), written off interest on corporate back taxes. Given the high inflation rate in Serbia, when interest is written off, so is part of the principal that has decreased in value due to inflation. When inflation is taken into account, a zero interest rate on tax liabilities actually becomes a negative interest rate. So, for instance, if interest on 3-year-old back taxes is written off, assuming inflation stands at 10 % per year, the principal of the tax debt will lose 27 % of its value. By writing off interest on back taxes the government systematically rewards non-conscientious taxpayers and directly encourages moral hazard. This means that some taxpayers who are eminently able to pay their taxes choose to wait for interest to be written off and their tax debt reduced. Writing off interest on tax debts hurts the level playing field for all participants in the market and fosters negative selection, whereby undisciplined taxpayers are rewarded and disciplined ones are not.

The adoption of a new Law on the Write-Off of Interest for Late Payment of Taxes will temporarily improve liquidity in the economy, as well as the inflow of

funds to the budget. However, the long-term effects of this law on financial discipline will be markedly negative, since it represents the continuation of the practice of periodically rewarding undisciplined taxpayers by writing off a portion of the real value of their principal debt along with nominal interest. Thus the practice of writing off interest on back taxes should be discontinued, since it rewards non-compliance and enables insolvent companies to remain in the market.

Improve the Quality of Services Provided by the Government

Taxes are the price that the public pays for services provided by the government. Thus the readiness of the public to pay taxes depends on the actual volume and quality of public services, and on individual perceptions of the provided services. Low quality of public services, unproductive expenditure, and corruption affect the readiness of the public to pay their taxes. Improving the efficiency of the government by enhancing the quality and availability of its services (from security and justice to education and healthcare) is important for tackling the shadow economy.

Educate the Public About the Importance and Value of Services Provided by the Government

In addition to improving the quality of government services it is necessary for the government to work on the perception of the public regarding the value of those services. The public often underestimate the value of the services provided by the government: a year of elementary school, certain forms of healthcare, social security, agricultural subsidies, etc. This bias creates a widespread conviction among the public that the taxes they pay are much greater than the value of the services provided by the government. This belief, which is partly true, increases the willingness of people to not pay their taxes. It would be beneficial, therefore, for brochures to be periodically mailed to all households (modelled after the ‘citizen’s budget’ prepared in many developed EU member states) explaining in clear and easily understandable language how much the government spends for what purpose and why it is important for individuals and businesses to pay their taxes regularly.

9.2.3 Measures Relating to Features of the Labour Market

Taxation of Labour

The most important recommendation in the field of labour taxation pertains to the need to substantially reduce labour costs for lower-paying jobs. Any kind of reform of labour taxation (or, in a broader sense, of the taxation of income derived from

work) should ideally entail an increase in the tax-exempt personal allowance to the level of the minimum wage. Most European countries employ this practice.

Tax allowances for family dependents in Serbia are available only to annual income tax payers, i.e., the richest 1 % of the population. Introducing a tax-exempt allowance for dependents would reduce the tax burden of employees with an unemployed spouse and children, and thereby reduce their incentives for joining the shadow economy.

Another means of reducing the tax burden on lower wages would be the removal of the minimum social security base, which now stands at 35 % of the average wage. While its impact on people working full-time jobs is negligible since the minimum wage is far above this level, it increases labour costs for part-time workers with standard open-ended employment contracts.

In addition to removing the minimum base for social insurance, an important incentive to formalising informal employees working part-time jobs would be the introduction of less restrictive tax treatment of so-called ‘mini jobs’ and ‘midi jobs’, based on the positive experiences of Germany (Eurofound 2008) where healthcare and social security contributions for mini jobs (defined by the wages earned rather than by hours worked) are much lower than standard, while the rate of income tax can even equal zero. Midi jobs (where wages lie between those of mini jobs and standard employment) attract contributions that are greater than those for mini jobs but are still lower than standard. These rules ensure that workers in mini jobs avoid the trap of wage poverty and ease their transition into standard employment.

Seasonal workers in agriculture, tourism, and other seasonal activities may find the Montenegrin solution beneficial: employers there are required to pay a fixed amount per day for each seasonal employee.

Some countries have also introduced progressive contributions for social security or contribution rates that differ by sector, with labour-intensive, lower-paying sectors of activity (where the shadow economy is generally more widespread) paying contributions at lower-than-standard rates. Empirical, theoretical, and legislative arguments for and against the introduction of such differentiated rates in Serbia deserve careful consideration.

Minimum Wage Regulation

To avoid driving down the demand for formal work, the minimum wage should be reduced from the current level of 50 % to some 35 %–40 % of the average wage, as was the case in Serbia until several years ago and as recommended by the World Bank for middle-developed countries. Moreover, the introduction of a slightly lower minimum wage for youth under 25 years of age should be considered, to stimulate their open-ended employment. Similarly, the minimum wage could vary slightly by region so as to partly reflect regional differences in the cost of living (which is slightly higher in Belgrade than in the rest of Serbia).

Working Hours Regulation

The body of regulations governing working hours should be carefully analysed to see which of the current standards are more costly for employers or do not benefit workers, and an effort should be made to change them. The suggestions made below are based on comparative data on prevailing practices in OECD countries and on employers' most common complaints.

- Slightly reduce increased hourly rates for overtime and work on weekends and holidays.
- Allow more flexible re-allocation of working hours, both within the working week and for longer periods of time, subject to the consent of both employee and employer.
- Allow annual leave to be used as agreed between employee and employer.

Employment Protection Legislation

The most urgent requirement in this respect is the removal of the statutory provision obliging employers to pay employees severance in proportion to each employee's total years of service rather than only years of service spent with that employer. This would foster formal employment, primarily of elderly workers with work experience.

In addition, the maximum length of employment under individual fixed-term contracts should be extended from 1–2 or 3 years. This change would probably not have a major impact, as breaches of this rule are rife, with businesses extending such contracts beyond the statutory maximum by manipulating job titles. Nonetheless, this change must be made to give the most compliant businesses (frequently foreign investors, who are also the ones objecting the most to this provision) more flexibility in adjusting the volume and structure of their workforce. In addition, a better general principle is to comply with a good rule than not to comply with a bad one.

Retirement Rules

An increase in the formal employment of elderly workers, as well as a parallel drop in their undeclared work, would be achieved by raising the current retirement age threshold, introducing actuarial adjustment of pensions to reflect the life expectancy of people who retire earlier, and providing for actuarial rewards for those who continue to work and pay pension contributions after meeting conditions for full retirement, regardless of whether they receive pensions or not.

Welfare Benefits

In Serbian practice, welfare benefits are available almost exclusively to unemployed and inactive persons, which lead those who are able to work to combine welfare and informal employment. To incentivise employment in the formal sector, an in-work benefits programme should be introduced along the lines of the US Earned Income Tax Credit, which would make it possible for workers to combine formal employment and welfare benefits, with the latter gradually reduced as earnings increase.

Specific Measures Targeting Informal Employment

Evaluations show that various specific measures targeting informal employment are more beneficial than a blanket reduction in tax rates, which can have much broader implications and not sufficiently reflect a reduction in the shadow economy (Eurofound 2008).

An example of a targeted programme is support for formal self-employment. This measure is applied in Serbia by the National Employment Service (NES), and it involves a one-off non-repayable grant and some in-kind support, provided that the beneficiary regularly pays contributions and taxes for at least the following 2 years. On average, some 3,000–5,000 people per year become self-employed through this programme; NES staff estimate that most of them merely formalise their informal businesses. It is interesting to note that evaluations show that entrepreneurs who have been legalised have higher survival rates than those who start businesses without previous experience in the informal sector.

Some European countries apply a broader range of support measures to ease the shift from unemployment or informal employment towards formal self-employment. A special programme is available in the Netherlands that offers tax breaks for relatives and other persons who lend start-up money to those without jobs. Germany subsidises the unemployed who start their own business for 3 years; the subsidies decrease gradually over the course of the 3-year period (Eurofound 2008). In Serbia unemployed persons can receive the entire amount of unemployment benefits to which they are entitled in advance, on condition they use the money for self-employment.

Micro lending is also a measure that facilitates the establishment of legal sole proprietorships, especially for those categories of people who cannot rely on their own funds or commercial credit. Formal borrowing is believed to increase the likelihood of a business becoming formal (Eurofound 2008).

Recommendations for Improving the Efficiency of the Labour Inspectorate in Tackling Undeclared Work

An analysis of the position, operation, and volume of activities undertaken by the Labour Inspectorate shows that this body has been achieving relatively good results in terms of addressing undeclared work, given the constraints on its operation imposed by regulations, limited human resources, and lack of other capacities. This finding is further borne out by the fact that 56 % of all respondents in the Survey on Conditions for Doing Business in Serbia awarded good marks (4 and 5 on a scale from one to five) to the Labour Inspectorate, while a mere 12 % gave it poor marks (1 and 2 on a scale from one to five). This result is slightly better than that achieved by the other two institutions in charge of tackling the shadow economy, the Tax Administration and Market Inspectorate.

As has already been demonstrated using a multitude of examples, one of the key problems in the operation of the Labour Inspectorate is the lack of co-ordination and integration with other inspection and oversight services. This problem could be overcome by integrating the various inspection services into an Inspectorate-General (of which the Labour Inspectorate would be a part) to achieve synergy and avoid duplication of activities, while at the same time establishing a consistent system that would be more efficient at preventing some of the most dangerous participants in the shadow economy (such as ‘phantom companies’) from operating with virtual impunity by using loopholes in existing legislation.

Changes to legislation should be considered that would allow labour inspectors to access and examine all premises where business is conducted, regardless of whether the entities in question are formally registered or not. In addition, it would be beneficial to allow labour inspectors to impose fines as part of a simplified procedure.

A long-standing complaint of the Labour Inspectorate is that they have too few people and too much work, and that the number of inspectors needs to be increased substantially if optimal results are to be achieved. Inspectors are well qualified, and nearly all of them have university degrees. The Inspectorate has limited Information and Communication Technology (ICT) capacity. There are electronic linkages with the Business Registries Agency and an internal analytics and planning database has been developed. However, the Inspectorate cannot establish direct links with business records, the Tax Administration, the National Employment Service, or social security organisations.

The key measures for removing administrative barriers are better co-operation between the Labour Inspectorate and the Tax Administration, social security organisations, the police, and courts. Moreover, co-operation with the National Employment Service is tenuous: the database of people receiving unemployment assistance is not available to the Inspectorate, which is an issue that needs to be resolved.

Recommendations for Improving the Efficiency of the Market Inspectorate in Tackling the Shadow Economy

The broadest recommendation in an institutional sense entails the drafting of a framework Inspections Law, harmonised with European Union regulations, to ensure better mutual co-ordination of inspection oversight and better delimitation of the powers of the various inspection services. This piece of legislation would also allow the closure of numerous loopholes in the powers of inspection bodies that have made it possible for the shadow economy to flourish and have hindered the implementation of activities designed to combat it. A commission to co-ordinate inspection oversight should be established as quickly as possible. The advantages of an integrated inspections approach are particularly obvious in the area of authority of the Market Inspectorate. A unified database of offenders and offences, accessible to all inspection services, the Tax Administration, the Customs Administration, and the police, would improve the efficiency of the fight against the shadow economy. The integration of powers would mean that inspectors that uncover an unregistered or unreported entity or person engaging in an activity under the remit of another inspection agency would be both authorised and required to demand that any deficiencies be remedied and to notify the Tax Administration of the infringement and the measures taken.

Specific recommendations for improving the efficiency of the Market Inspectorate have been made as part of the Regulatory Reform Project and USAID BEP. In addition to the above, these include the need to re-organise it along territorial lines and reduce the number of regional units, as well as to strengthen its functional organisation to ensure more complete oversight of the trade in specific goods throughout the country. Furthermore, inspectors should act solely pursuant to audit orders: this would avoid arbitrariness and guarantee adherence to the hierarchy and transparency of inspection oversight. A risk assessment system should be introduced (to focus on the likelihood of non-compliance or infraction), as should a risk management system for inspection oversight. Among the changes needed are more training for inspectors, new software development, and better public information about the work of the Inspectorate. Periodic outreach campaigns should be organised aimed at both offenders and the general public; we will go into this issue in greater detail at the end of this chapter.

9.2.4 Measures Relating to the Financial Sector

Curb Transactions in Cash and Incentivise Cashless Payments

Cash transactions involve money changing hands without the use of bank accounts, and are also termed ‘cash-in-hand’ payments. These transactions are not formally registered. In addition, in highly dollarised economies such payments are predominantly made and received in foreign currency.

Cashless and, particularly, electronic payments are among the means that can be used to reduce the volume of cash transactions, both formal and informal. Electronic payments therefore make it more difficult for parties to operate in the informal sector (Schneider 2011).

In the case of Serbia, an anti-crisis measure exempting certain entities from the requirement to use fiscal cash registers does not seem to have resulted in better reporting of cash transactions, nor in a decrease in the shadow economy. On the contrary, it has facilitated informal cash transactions.

In addition to reducing the volume of cash transactions, greater use of cashless payments would increase reporting, particularly by businesses and small entrepreneurs, and thereby make it impossible to conceal any portion of revenue generated in cash. Several measures can be implemented to boost the share of cashless (primarily electronic) payments in Serbia.

Incentives need to be preferred over repressive measures against the use of cash in financial transactions. Given the rapid pace of technological development, it is relatively easy to allow payments using electronic money so that sellers of goods and services are compelled to offer electronic payments in sectors presently dominated by cash payments (catering, taxi cabs, etc.). There are also many incentives that can be used, such as subsidising point-of-sale terminals for small and micro-businesses, limited tax incentives for electronic payments (as introduced by Argentina, Colombia, and South Korea), and prepaid cards for people without bank accounts to enable their inclusion in the formal sector. On the macroeconomic level, government subsidies and assistance could be paid out electronically, as could various types of contributions (as is the case in Russia). Further, all government payments could be limited to electronic channels only.

Cash payments can be constrained directly. For instance, an Italian law dubbed the *Decreto Bersani* (D. Lgs. 7/2007) imposes a €100 limit on cash payments for professional services on pain of a strict prison sentence.³ Bulgaria is an interesting example when it comes to applying restrictive measures. In 2011, Bulgaria introduced a law restricting cash payments, which sets out conditions for limiting payments in cash in its territory, which should reduce the extent of the shadow economy (Bulgarian Ministry of Finance 2011). Besides the implementation of measures aimed at limiting cash payments, more effort should be put into educating users of payment cards about their uses and benefits.

Moreover, economic policymakers should reach a clear consensus on the application of a de-euroisation strategy. This would contribute to a substantial reduction in cash payments—particularly informal ones—throughout the system. The

³ In addition to simplifying start-up procedures (Art. 9), the *Decreto Bersani*, adopted in 2007 (D. Lgs. 7/2007) introduced strict penalties for activities in the shadow economy. As such, it is a good example of measures designed to tackle informal activity. The penalty for a construction company employing undeclared workers is the closure of its construction site. A retail outlet caught not issuing fiscal receipts three times in 5 years can be closed down permanently. Finally, the *Decreto Bersani* prohibits cash payments of more than €100 for professional services rendered.

environment would then favourably affect macroeconomic stability, further driving down the shadow economy.

Finally, to ensure that the remaining cash transactions take place primarily within formal channels, field audits should be strengthened to ensure fiscal cash registers are used and receipts are issued for all transactions.

Formalise Remittances from Abroad Transferred Through Informal Channels

In the opinion of businesspeople, greater transfer of funds using formal channels (primarily the banking sector, money transfer agencies, and the post office) could be achieved by reducing transfer costs (commissions and fees). Greater formality would also increase transparency and facilitate the use of these funds to finance activities that contribute to the growth and development of the recipient country (Jongwanich 2007; Ratha and Mohapatra 2007; Ratha 2009; Ratha and Silwal 2012).⁴ Serbia has high transfer costs compared with the global average, which has been estimated at about 9 % of funds remitted (World Bank 2012). What is more, in Serbia commission charges on incoming money transfers are higher for smaller amounts (in percentages), which disincentivises emigrants from sending money through formal channels.⁵

Greater competition of entities that transfer funds formally and lower transfer costs would increase migrant interest in sending remittances through formal channels and offer numerous benefits to recipients, who are mainly people with lower incomes. These benefits include easier access to financial institutions, cheaper finance available to a larger share of the population, lower investment risk due to easier diversification, and better education of recipients of remittances about alternative ways of using those funds.

Formal transfer channels should be easier to access, more reliable, faster, and cheaper than competing informal channels. The choice of more expensive formal and informal channels is often driven by the loss of anonymity inherent in bank transfers. Regulators of countries where funds are sent and received should enter into appropriate bilateral agreements to formalise and facilitate the transfer, channelling, and registration of funds received (see, for instance, the experience of Mexico in Hernández-Cos 2005). This process can take the form of a public-private partnership with the participation of financial institutions. Establishing closer co-operation between the banking sectors of countries where remittances

⁴The costs of transferring funds into Serbia using specialised money transfer agencies are, on average, 10–15 % (commission plus exchange rate difference), while the individual sums transferred average between €100 and €300 each.

⁵Several commercial banks in Serbia have, of their own accord, successfully cut remittance transfer costs severalfold to an average of 0.2–0.4 % of the sum remitted. This is an improvement, but still does not bring Serbia up to par with countries that apply fixed commission charges regardless of the amount remitted.

originate and receiving countries should reduce transaction costs and accelerate transfers using this formal channel.

To ensure adequate competition between institutions that participate in the transfer process, regulations governing the various players in the market need to be harmonised, giving due consideration to the protection of the services' clients. The role of the regulatory bodies would include oversight of transfers to reduce the risk of any form of abuse and mismanagement of funds and to increase client confidence in this transfer mechanism. A greater role for banks in the transfer of remittances should reduce transaction costs and increase the speed and reliability of the service. This could be achieved by developing a single clearing system to be shared by the participating countries.⁶ Easier access by a greater share of the population to financial services provided by banks and other financial institutions should boost domestic savings and the use of remittances for investment.

Greater investment of remittance funds needs to be stimulated by a good investment climate in the migrants' country of origin and investment incentives (e.g., tax breaks). The Law on Foreign Exchange Operations (*Official Gazette of the Republic of Serbia*, No. 62/2006, Art. 29) and its amendments (*Official Gazette of the Republic of Serbia*, Nos. 31/2011 and 119/2012) make it possible to repatriate non-resident profits generated in the local economy after taxes are paid, unless otherwise specified.

Formalising the channels used for remittance inflows would also enhance the efficiency of the financial sector through economies of scale resulting from greater inflow of funds and more services provided (Gupta et al. 2009; Aggarwal et al. 2011). This would also allow for these institutions to become more involved in encouraging entrepreneurship and other investment by using the funds received to attract deposits and offer loans, advisory services, insurance, and custody operations. The largest banks would stand to benefit most from these transactions, as they could offer the greatest volume of services and reduce transaction costs the most. By providing affordable remittance transfer services, they could induce both migrants and their family members in the country of origin to purchase other profit-making services offered by the bank.

The stability of remittance inflows has led some developing countries (e.g., Turkey and countries in Latin America) to use them as collateral in new bank borrowing and on-lending cycles.

As the greatest share of remittances sent through formal channels are electronic transfers, appropriate infrastructure to access these funds needs to be put into place throughout the receiving country. The development of technical and IT infrastructure at the local level could be funded through public-private partnership, and the project approved by the development bank of the country in question or another regulatory body. A well-developed infrastructure to support money transfers from

⁶ According to data made available by the Ministry of Religious Affairs and the Diaspora, the number of Serbian expatriates is estimated at about four million. Most remittances are sent from Western Europe, particularly Austria and Germany, as well as from Serbia's neighbours.

abroad would also facilitate access to other financial services (such as current accounts, savings accounts, and credit instruments) for a broader section of the population.

Further development of formal remittance transfer channels would, in time, lead to the development of innovative products to help migrants invest directly in their country of origin by, for instance, purchasing land or real estate.

Moreover, special programmes could be set up to combine remittances sent by groups of migrants with funds provided by the central government or local authorities to jointly finance infrastructure projects of local or public importance (such as schools, hospitals, roads, sports centres, churches, parks, irrigation, electricity supply, computers, medical supplies, etc.).

The sending and registration of remittances should be regulated gradually, so that these flows can be better studied and this segment of the market developed without excessive and hasty government intervention, which could retard or disincentivise additional remittance inflows.

These and other possible enhancements of the regulatory environment and the financial system would contribute to greater inflows of remittances into Serbia through formal channels and their more efficient channelling into investment, which can be expected to have a positive impact on the economic growth and development of the country.

9.2.5 Measures Related to the Business Environment

These measures that have an impact on the conditions for doing business will be examined from the point of view of whether they are aimed at business entities that already operate in the formal sector but carry out some or the majority of their activities in the shadow economy, or are directed at entities completely in the informal sector.

Measures Aimed at Business Entities Operating Partially in the Shadow Economy

Resolve the Issue and Consequences of ‘Phoenix Companies’

‘Phoenix companies’, entities that transfer assets to a newly formed business while leaving debts vested in an old one, make a substantial contribution to the chain of illiquidity, primarily with regard to small and medium-sized businesses, which in these circumstances are forced to move part of their activities into the shadow economy. There are several options for resolving this issue. The first one involves the ex-post introduction of a special Registry of Bans, similar to the already extant Court Ban Registry, which would serve as a record of all bans imposed on managers and owners of businesses facing criminal or other proceedings (e.g., under

Art. 46 of the Misdemeanours Law, which provides for bans on the performance of a particular activity). Numerous countries have similar registration regimes in place (such as Estonia, Norway, the UK, Ireland, and Macedonia). Regardless of this, the Business Offences Law, Misdemeanours Law, and Criminal Code must begin to be consistently implemented, as they govern fraudulently causing insolvency and other business crimes that damage creditors and jeopardise the exercise of their rights. Another approach would ex-ante prohibit individuals from managing a business and establishing new entities when their existing business has been operating with a frozen bank account for in excess of a certain number of days, has not been filing financial reports, or has not been paying taxes. However, applying the second option might create the wrong incentives and penalise those who are not actually responsible so that introducing manager disqualification would prove counter-productive. In addition, regardless of which solution is adopted to ban operating in any capacity, both approaches will have shortcomings if regulations are not implemented consistently, as it will not be possible to prevent the establishment of new entities by other parties or foreign off-shore centres. Another option open to dishonest businesspeople is to establish several firms in advance as a precaution, and then use them one by one.

Impose Barriers to the Introduction of New Administrative Burdens by Requiring the Application of the SME Test and the Standard Cost Model⁷

The Small and Medium-Sized Enterprise (SME) Test is designed to assess the impact of new regulation on small and medium-sized businesses in order to avoid imposing disproportionately large burdens on them. Although Article 40(2) of the Rules of Procedure of the Serbian Government stipulates that a regulatory impact assessment should contain information on the costs that a new piece of legislation will impose on SMEs, this is not sufficiently comprehensive, and should be replaced by a provision requiring the inclusion of the SME Test as an integral part of the assessment. The SME Test should, above all, examine the proposed legislation from the point of view of its suitability for the SME sector to see whether SMEs should be partly or fully exempt from the new regulatory requirements, as well as estimate or quantify the annual costs faced by micro, small, and medium-sized enterprises. The Regulatory Reform Office has already developed the SME Test but it is yet to be implemented. The second approach involves the Standard Cost Model (SCM), which measures the overall administrative cost and the burden of new administrative requirements and has been developed by the Regulatory Reform Office in the form of a turnkey software application. The use of this tool is

⁷ Since 2008 the European Union has been implementing the Small Business Act as a new framework for SME development policy. As the act is part of the *acquis communautaire*, its significance for EU candidate countries is also substantial. The SME Test is an integral part of the EU's regulatory impact assessment procedure.

yet to be mandated for amending administrative requirements or introducing new ones. The consistent and mandatory use of the SCM could prevent undue administrative burdens. Both methods have become integrated into the European Commission's regulatory impact assessments and are used in many EU member states.

Simplify Regulatory (Administrative) Requirements

The aim of the Comprehensive Regulation Reform effort and NALED's⁸ (2012) *Grey Book V* is to identify, with the active participation of businesses themselves, administrative burdens and procedures that unduly constrain doing business and to find the simplest solutions for removing them. Practice has shown that the problems identified are resolved too slowly, which creates additional costs for business entities. Some issues, such as the removal of 'turnover and incoming payment ledgers' and the abolishing of complicated pregnancy and maternity leave procedures, have been in the pipeline for several years. Instead of acting on an ad hoc basis, the government needs to adopt a clear plan for removing unnecessary administrative requirements and report to the public on its realisation.

Regulate the Public Consultation Process

In contrast to European Union practice, stakeholder participation in the legislative process in Serbia is often unsatisfactory. In the EU a minimum of 8 weeks is set aside for public consultation. According to Transparency Serbia, statutory provisions governing public comment periods in Serbia are inadequate. Among other things, there is no pre-defined form of public debate and no sanctions if a public body fails to launch such a debate. Non-compliance with the law by public authorities is compounded by the frequently passive stance of business entities. There are multiple reasons for this behaviour. Businesses often lack the necessary time and resources or simply do not feel that they can change anything. Serbian laws stipulate that a public comment period is mandatory where a proposed piece of legislation significantly changes the statutory treatment of a particular area, or where the issues at hand are of particular interest to the public. Except for this requirement imposed on the legislator, public consultation is not governed in greater detail. In some cases there is no public comment period but it essentially takes place by other means (e.g., in roundtables, public gatherings, etc.). To improve the current situation the minimum requirement could be the posting of a proposed piece of legislation on the web site of a ministry or other regulator at least 8 weeks before that piece of legislation enters formal procedure. In addition, depending on the issues to be governed by the proposed regulations, as part of the

⁸ National Alliance for Local Economic Development.

law drafting process consultation with local authorities and legitimate representatives of business and other professional associations must be improved.

Adopt Bylaws in a Timely Fashion

One of the fundamental causes of legal insecurity is lateness in the adoption of bylaws, which makes it impossible to implement laws. When bylaws are not adopted in due time, new laws cannot be implemented, while old legislation lapses.⁹ Faced with this legal vacuum, business entities are often forced to make do without knowing whether they are operating in accordance with the law or if their activities fall within the scope of the shadow economy. The legal insecurity created by this situation has major consequences for the economy. There are several options that can be considered. One (admittedly extreme) option is not to allow a draft document (or bill) to begin the procedure of becoming law without all bylaws being ready. Another option is to make the existence of guidelines for drafting specific bylaws the minimum condition for beginning the procedure. A third option would be to make it impossible to implement a law without providing a detailed explanatory note stating how it will affect the private sector, including calculations of costs and a detailed consideration of the specific requirements to be governed by bylaws. Finally, realistic deadlines should be set for the adoption of bylaws.

Improved Protection from Unfair Competition

The Law on Trade prohibits unfair competition; that is, actions of a business aimed against another business that damage or may damage a competitor through untrue or insulting claims regarding that business, or through the sale of goods whose labels, packaging, or shape create justifiable confusion regarding the quality or other characteristics of such goods. However, there are substantial problems with the application of the law. The Ministry of Trade has introduced a Bill Amending and Supplementing the Law on Trade, currently undergoing parliamentary procedure, which includes a new article whereby businesses will be able to seek intangible damages for harm to their reputation arising from unfair competition. However, while this change will improve current legal framework, the implementation has to be substantially improved.

⁹ According to an analysis carried out by NALED in 2012 (NALED 2012), only three bylaws were adopted before the deadline, 33 were adopted after the deadline, while in 163 cases the deadline expired before the bylaws were adopted.

Measures Directed at Business Entities Operating Wholly in the Informal Economy

Establish an E-Portal for Licences, Permits, Approvals, and Consents

Although reform of the registration process has made it much easier to incorporate a business entity, in some sectors of activity there remain a large number of administrative requirements that an entity must meet. When filing for permits and approvals, business entities often face administrative requirements that leave them unsure what to submit, which steps to take, or which body to contact. A solution already implemented in the region is an e-portal for licences, permits, approvals, and consents that would contain detailed information, directions, documents, and contacts to make it easier to start a business. Immediately after being incorporated, although formally registered, businesses often cannot legally engage in an activity while they wait for an approval or licence. To bridge this gap businesses begin doing part of their business in the informal sector, and continue doing so even when the licences are finally received. This e-portal could be made part of the e-Government web site and contain instructions for each individual sector. Another option would be to host it on the Business Registries Agency web site.

Remove Barriers to Entry in Particular Sectors

Over the past several years new requirements have appeared that business entities have to meet before they can begin operating in a particular sector of activity. While in some sectors these are justified, in others they are typical barriers to entry, set up to protect current participants in the market. Recent examples are the introduction of a solicitors' examination and the review of regulations governing the profession of tourist guide. If a portal for licences, permits, approvals, and consents is established, existing requirements could be analysed, some procedures could be simplified, and, finally, some requirements could be abolished. In addition, efficient implementation of the Competition Law plays a major role in removing barriers to entry and it must be substantially improved.

Establish an Authoritative Registry of Legislation Accessible to the Public Free of Charge

Among the constraints faced by new start-ups are the costs they must meet to obtain information that is, by its very nature, in the public domain. Small businesses usually rely on their bookkeepers or lawyers, but they should also be allowed to access a legislation database. *Službeni Glasnik* ('Official Gazette'), the public body tasked with publishing authoritative texts of legislation in the journal of the same

name, has of its own initiative developed a database of legislation containing revised texts of current regulations and PDF files of the relevant issues of the Official Gazette where the regulations and their amendments are published. This database can be considered authoritative in the sense that all of its users are able to rely on the authenticity of the contents of the PDF files. Public access to this database would significantly reduce transaction costs at the level of the entire economy, and in particular would make it easier for new start-ups to operate and to reduce their expenses.

Construction Permits and ‘Legalisation’

The construction permit procedure is inefficient and lengthy due to a very complicated system that involves filing for permits with a large number of entities. Unable to obtain permits, some business entities start construction illicitly, at great risk. Developers (or investors) hire workers from the informal sector and engage businesses and entrepreneurs that do not declare such work. Accelerating construction permit procedures, decentralising authority, establishing ‘one-stop shops’ at local authorities, changing the role of public entities in the permit procedure, harmonising procedures, drafting plans, etc. would all greatly contribute to shifting construction activities into the formal sector.¹⁰

Another serious issue is the ‘legalisation’ of buildings, i.e., the subsequent issuance of construction permits for unpermitted properties. According to available data, nearly 700,000 buildings constructed without permits have been reported to local authorities; sources indicate that there are 1.3 million unregistered buildings. This legalisation procedure must be simplified to incorporate clearly defined and restricted deadlines, while the fees for subsequent issuance of permits must be based on economic criteria.

9.2.6 Outreach Campaigns

Outreach campaigns should play a particularly important role in the implementation of the proposed measures, which should have an impact on reducing tax evasion and encourage entities to move from the informal to the formal sector. Outreach campaigns should clearly point out the risks and expenses associated with operating in the shadow economy and the benefits of formalisation, or aim to change their audiences’ views of the morality of tax evasion.¹¹

¹⁰ Detailed proposals for resolving construction permit issues are presented in the Assessment of Constraints to Construction Permits in Serbia, prepared for the USAID Business Enabling Project (2012).

¹¹ The most important outreach campaigns in the region have been ‘Take the Receipt’ in Serbia in late 2004, and ‘VAT is Your Money’, which is still in progress in Montenegro.

These campaigns should be aimed at both participants in the transaction: where they focus on tax evasion their target should be both buyers and sellers and if the topic is employment they should target both employers and workers. The campaigns should be general but should focus on sectors where the shadow economy is most widespread (such as construction or transportation), or on particular social or demographic segments of the population (particularly on those groups, such as young people, who believe activities in the shadow economy are an acceptable form of behaviour).

The International Labour Organisation and the European Union recommend the use of information campaigns to combat the shadow economy. Education campaigns targeting taxpayers, the media, and the general public should be intensified to maximise impact.

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